1974

Accounting for research and development and similar costs : responses to issues raised in FASB Discussion Memorandum, December 28, 1974 (FASB file reference 1007), February 28, 1974; Statement of position 74-01;

American Institute of Certified Public Accountants. Accounting Standards Division

Statement of Position

74 - 1
(FASB)

on

ACCOUNTING FOR RESEARCH AND DEVELOPMENT AND SIMILAR COSTS

February 28, 1974

Responses to issues raised in
FASB Discussion Memorandum, December 28, 1974
(FASB File Reference 1007)

issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING FOR RESEARCH AND DEVELOPMENT AND SIMILAR COSTS

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants has considered the Discussion Memorandum, Accounting for Research and Development and Similar Costs, dated December 28, 1973, of the Financial Accounting Standards Board and has formulated on behalf of the Accounting Standards Division this statement of Position on the twelve major issues in that document. This position paper has been prepared using as a frame of reference existing accounting principles concerning the nature of assets and liabilities, revenues and expenses. The Division recognizes the possibility that a different frame of reference may have produced different comments.

Issue One: What Activities are Encompassed by Research and Development?

The Division recommends that broad guidelines be adopted to describe the nature of research and development and its related costs.

The variety of companies, industries and research and development programs is too great to permit a detailed prescription. The adoption of broad guidelines would not preclude more detailed agreement on a voluntary basis within an industry and, in fact, it would be desirable for the FASB to recommend that individual industry associations attempt to establish common industry definitions and practices within the broad guidelines.

It is the Division's belief that the nature of most accounting standards should be broadly stated objectives or guidelines which can be applied to a wide range of situations or circumstances. Standards should not be so detailed that they appear to be inapplicable to many prospective situations because those situations are not mentioned specifically. In addition, detailed standards lend themselves to interpretations favoring form over substance.

Issue Two: What Elements of Costs Should be Identified With Research and Development?

The Division recommends that an allocation of indirect costs as well as direct costs be included in the elements of costs identified with research and development. The Division believes that indirect costs allocated to research and development should be comparable to those which are generally included in inventory as factory overhead.

This general view is held in differing degrees within the Division depending upon the specific component of indirect costs being considered and upon the conclusion as to the appropriate accounting for research and development costs when incurred. Thus, some members who support the allocation of indirect costs to research and development if research and development costs are expensed when incurred would not support allocation of some or all indirect costs if research and development costs are capitalized.

Issue Three: What is the Nature of Certain Other Costs That are Similar to Research and Development?

The Division has concluded that the three distinguishing characteristics outlined in the Discussion Memorandum are inadequate for determining those other costs which are similar in nature to research and development costs for accounting purposes. They do not delineate the characteristics clearly enough to provide assurance that different persons applying them would reach reasonably consistent conclusions as to whether or not a specific cost was similar to research and development cost. For example, it is not clear whether expenses incurred by life insurance companies in acquiring new business meet the three criteria. The Division believes that more definitive criteria need to be developed. In the absence of such improved criteria, the FASB Statement should be limited to research and development costs pending further study.

Issue Four: What is the Appropriate Accounting Treatment at the Time Research and Development Costs are Incurred?

The Division is representative of a wide variety of backgrounds and experiences which were brought to bear on this most controversial issue. In spite of this diversity a number of important conclusions have been reached.

First, the alternative that all costs be capitalized when incurred was unanimously rejected. The bases for rejection included the wide range of such costs, the very tenuous relationship between some costs and any future benefits, and the high degree of uncertainty of recoverability of many costs.

Second, although a few individuals favored the alternative that all costs be accumulated in a separate category, a large majority rejected that alternative, generally for the reasons stated in the arguments against the alternative on pages 40 and 41 of the Discussion Memorandum.

Third, a large majority favors expensing when incurred research and development costs of a continuing nature such as those described in the Gellein and Newman study as the costs of continuing research programs.[1/] These costs usually result from a relatively permanent activity whose objective is to maintain the entity and therefore should be accounted for as period costs.

These conclusions represent a substantial area of agreement.

There is a rather wide dispersion of views as to accounting for costs outside the area of continuing research programs. These views range from those which correspond roughly to the position espoused by Gellein and Newman to those under which all costs that ultimately cannot be assigned to conventional cost centers such as inventory or fixed assets would be expensed when incurred. The range of views stems primarily from different weight being given to the various arguments stated in the

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1/ Accounting Research Study No. 14, Accounting for Research and Development Expenditures, by Oscar S. Gellein and Maurice S. Newman, American Institute of Certified Public Accountants, Inc. (1973).

Discussion Memorandum. To a lesser extent it stems from a definitional problem as to when research and development activity ends and some other activity, such as production or construction, begins. In general, there is little support within the Division for capitalization criteria less stringent than those proposed by Gellein and Newman with perhaps a bent toward more conservative criteria.

Throughout these deliberations major concern was registered as to the ability to make prudent judgments concerning future benefits and this must be considered the most important single factor which has shaped the conclusions reached. This attitude is undoubtedly based on difficulties encountered in prior audit experiences with the making of such judgments.

Issue Five: What is the Appropriate Subsequent Disposition of any Costs not Initially Expensed?

The Division recommends systematic amortization, commencing upon commercial production of the given product, together with partial or complete write-off when appropriate, because research and development, no matter how successful, has a finite life and costs should be absorbed against the estimated revenues which justified capitalization.

The amortization policy should give recognition to both the estimated useful life of the object of the research and development activity and the estimated volume of future business. For example, it may be appropriate to amortize on the basis of estimated future sales quantities or revenues combined with an estimated useful life to acknowledge the risk of obsolescence and the greater degree of difficulty of making reliable estimates far into the future. The FASB Statement should also require continuous reappraisal of the amortization policy in the light of current circumstances.

Issue Six: How Should Research and Development Costs be Presented in Statements of Income?

The Division recommends that research and development costs be presented as a separate line item within the operating expenses section of the income statement. Reporting research and development costs as a special category of the income statement is considered an acceptable alternative. In any event, the amount should be included within operating income.

Issue Seven: What Special Disclosures, if any, Should be Provided About Research and Development Activities?

The Division favors substantially improved disclosures about research and development costs. These disclosures would provide a great deal of additional detail about amounts reported in the financial statements. In particular, the Division believes that the following information should be disclosed:

(a) A comprehensive summary of accounting policies.

(b) The aggregate expenditures for research and development during the period.

(c) An analysis of aggregate expenditures by major category pending completion of the FASB project, Reporting by Diversified Companies.

(d) Aggregate amounts expensed during the period with details of (i) amounts expensed when incurred, (ii) amounts amortized, and (iii) previously capitalized amounts written off as not recoverable.

(e) An analysis of capitalized research and development costs at the end of the period by major categories, together with the amounts related to each.

The Division does not favor requirements for disclosure within the financial statements of (i) general projections about new and improved products and services, (ii) estimated future research and development costs and (iii) general discussions of business philosophy about research and development activities. The foregoing is not intended to preclude disclosures about research and development activities that would be required by general disclosure standards.

Issues Eight and Nine: How Might the Distinction Between Established Operating Companies and Companies in the Development Stage be Delineated? Are the Differences Between Established Companies and Companies in the Development Stage of Sufficient Significance to Warrant Different Accounting Standards?

The Division believes that, consonant with the views expressed by the Ad Hoc AICPA Committee on Companies in the Development Stage in the July 1973 draft audit guide quoted in the Discussion Memorandum, a company in the development stage may be distinguished from an operating company by its activities and that the differences between the activities of the two are of sufficient importance to warrant different accounting. The reasons for these conclusions, which are interrelated, are generally those set out in the Ad Hoc AICPA Committee draft.

Issue Ten: What Different Accounting Standards, If Any, Are Appropriate for Companies in the Development Stage?

The Division believes that the primary accounting standards which should be different for companies in the development stage are (a) different accounting at the time costs are incurred, (b) different primary financial statement format, (c) special disclosures.

These areas are specifically described in the Ad Hoc AICPA Committee draft and no elaboration is necessary here. The Division wishes, however, to draw attention to the fact that the cost accumulation technique recommended in the draft is not equivalent to capitalization as that term is conventionally used by operating companies.

The Division notes that a number of the special disclosures described in the Discussion Memorandum go well beyond those recommended by the Ad Hoc Committee and are not relevant solely to companies in the development stage. The primary examples of these proposed disclosures are included in items (e), (f) and (g) on pages 66-68 of the Discussion Memorandum. Certain of these disclosures also give rise to serious auditing difficulties; for example, forecasts, sources of raw materials and information about directors and officers. Accordingly, the Division recommends that these disclosures not be included in any FASB Statement.

Issue Eleven: How Should Any Special Accounting Problem of Companies in the Development Stage be Dealt With?

The Division generally agrees with the conclusions reached by the Ad Hoc AICPA Committee on the five special accounting problems indentified in the Discussion Memorandum.

Issue Twelve: How Should Any New Accounting Standards be Applied Transitionally to Costs Incurred on Existing Projects?

The Division believes that the FASB Statement should be required to be followed in all financial statements for fiscal years beginning on or after a specified date, say January 1, 1975. However, the Division believes that financial statements for years prior to the effective date should refer to any impending changes which will be required by the FASB Statement.

Changes in accounting required by the FASB Statement, such as required capitalization or required expensing of costs, should be made retroactively by restating financial statements of all prior periods presented. However, the Division recognizes that, depending upon the conclusions reached by the Board as to Issue Four, information necessary to make complete retroactive adjustment may not always be available. In those cases -

(a) When it is impossible to make retroactive restatements of specific prior periods, the cumulative effect of the change should be reported in the current year in accordance with APB Opinion No. 20 (either paragraph 20 or 26, as appropriate) whenever that amount is determinable.

(b) When information is inadequate to permit the cumulative effect to be reported either retroactively or in the current year, the new standard should be applied to all costs incurred after the effective date.

The Division believes that the latter method generally is undesirable because of the lack of comparability which would be produced and should be used only when it is clearly impossible to do otherwise.

Accounting Standards Executive Committee

February 28, 1974

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